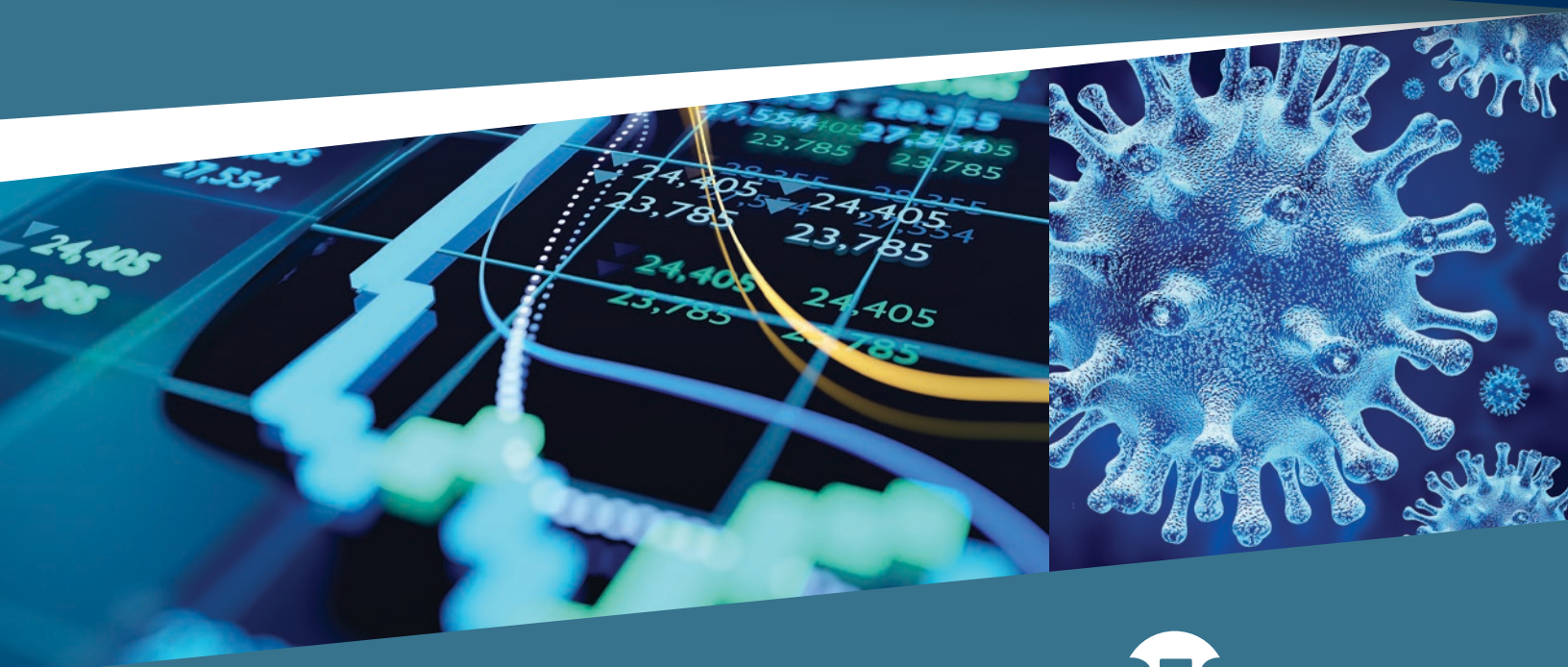


Sovereign Debt and Financing for Recovery

AFTER THE COVID-19 SHOCK

PRELIMINARY REPORT AND CONCLUSIONS OF THE WORKING GROUP



GROUP OF THIRTY



Disclaimer

This report is the product of the Group of Thirty's Steering Committee and Working Group on Sovereign Debt and COVID-19 and reflects broad agreement among its participants. This does not imply agreement with every specific observation or nuance. Members participated in their personal capacity, and their participation does not imply the support or agreement of their respective public or private institutions. The report does not represent the views of the membership of the Group of Thirty as a whole.

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Working Group on Sovereign Debt and COVID-19

STEERING COMMITTEE

Guillermo Ortiz, Co-Chair

Partner, BTG Pactual

Former Governor, Banco de Mexico

Former Secretary of Finance and Public Credit, Mexico

Lawrence H. Summers, Co-Chair

Charles W. Eliot University Professor,

Harvard University

Former Secretary of the Treasury, United States

William R. Rhodes

President and CEO, William R. Rhodes Global Advisors

Former Chairman and CEO, Citibank

Tidjane Thiam

Special Envoy for COVID-19, African Union

Former CEO, Credit Suisse

Jean-Claude Trichet

Former President, European Central Bank

Honorary Governor, Banque de France

PROJECT DIRECTORS

Anna Gelpern

Professor of Law and Agnes N. Williams

Research Professor, Georgetown Law

Nonresident Senior Fellow, Peterson Institute for

International Economics

Brad Setser

Steven A. Tananbaum Senior Fellow for

International Economics, Council on

Foreign Relations

WORKING GROUP MEMBERS

Arminio Fraga

*Founding Partner, Gávea Investimentos
Former Governor, Banco Central do Brasil*

Gail Kelly

*Senior Global Advisor, UBS Group AG
Former CEO & Managing Director,
Westpac Banking Corporation*

Mervyn King

*Member of the House of Lords, United Kingdom
Former Governor, Bank of England*

Maria Ramos

*Co-Chair of the Secretary General's Task Force on
Digital Financing of Sustainable Development
Goals, United Nations
Former Chief Executive Officer, Absa Group*

Tharman Shanmugaratnam

*Senior Minister, Singapore
Chairman, Monetary Authority of Singapore*

Mark Walker

*Senior Managing Director and Head of Sovereign
Advisory, Guggenheim Securities
Former Managing Partner, Cleary Gottlieb
Steen & Hamilton*

Axel A. Weber

*Chairman, UBS
Chairman, Institute for International Finance*

Zhou Xiaochuan

*President, China Society for Finance and Banking
Former Governor, People's Bank of China*

RESEARCH ASSISTANT

Alexander Nye

Table of Contents

Foreword	vi
Acknowledgments	vii
Abbreviations	viii
Introduction and Executive Summary	1
1. Boosting Global Reserves and Rationalizing IMF Financing Capacity	4
2. Concessional Surge Capacity in Multilateral Development Banks	8
3. Private Capital Market Access, Debt Overhang, and Comparability of Treatment	11
4. New Creditors, New Forms of Lending, a New Coordination Challenge: China's Leading Role	17
5. Comprehensive and Meaningful Public Debt Disclosure	20
6. Promoting Simple Contingent Contracts for More Resilient Sovereign Debt Stocks	22
7. Credit Ratings, Market and Regulatory Responses with Potential to Amplify Pandemic Shocks	24
Group of Thirty Members 2020	26
Group of Thirty Publications since 2010	30

Foreword

The Group of Thirty (G30) aims to deepen understanding of international economic and financial issues, and to explore the international repercussions of decisions taken in the public and private sectors. This report on *Sovereign Debt and Financing for Recovery After the COVID-19 Shock* continues the G30's long tradition of evidence-based, actionable studies.

The preliminary report highlights the importance and urgency of enabling fiscal resources in developing countries to be channeled towards critical needs in the near to medium term, and ensuring that they have access to financing to fuel growth and development in the years to come. It is also with this urgency that the G30 is issuing a preliminary report to focus attention and catalyze action on these issues, even as full recommendations are being developed and finalized.

The recommendations are practical steps towards sovereign debt sustainability, and making developing and emerging market economies more resilient to future shocks; conversely, policy inaction will hamper efforts to contain the pandemic and rebuild growth in the developing world, with consequences for all countries.

On behalf of the G30, we extend our thanks to Guillermo Ortiz and Lawrence Summers for their astute leadership of the Working Group behind the report, and to the Project Directors, Anna Gelpern and Brad Setser, for their capable construction of the report. We also thank those who participated in the study as Steering Committee and Working Group Members.



Jacob A. Frenkel
Chairman, Board of Trustees
Group of Thirty



Tharman Shanmugaratnam
Chairman
Group of Thirty

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On behalf of the Group of Thirty (G30), we would like to express our appreciation to those whose time, talent, and energy have driven this project to a successful completion of this preliminary report. We would like to thank the members of the Steering Committee and Working Group on Sovereign Debt and COVID-19, who guided our collective work at every stage. The intellect and experience of this diverse and deeply knowledgeable team was essential as we sought to craft the report's findings and recommendations on how best to prepare for and plan for possible sovereign defaults in the years ahead.



Lawrence Summers

Co-Chair

Working Group on Sovereign Debt

We extend our thanks to Project Directors Anna Gelpern and Brad Setser for their commitment and careful drafting and support. We also thank Alexander Nye for his research work on the preliminary report.

The coordination of this project and many aspects of project management, Working Group logistics, and report production were centered at the G30 offices in Washington, D.C. This project could not have been completed without the efforts of our editor, Diane Stamm, and the work of Executive Director, Stuart Mackintosh, and his team, including Desiree Maruca, and Emma Prall. We are grateful to them all.



Guillermo Ortiz

Co-Chair

Working Group on Sovereign Debt

Abbreviations

CACs	Collective Action Clauses
DSSI	Debt Service Suspension Initiative
G30	Group of Thirty
IDA	International Development Association
IMF	International Monetary Fund
MDB	multilateral development banks
NAB	New Arrangement to Borrow
RCF	Rapid Credit Facility
RDBs	Regional Development Banks
RFI	Rapid Financing Instrument
SDR	Special Drawing Rights

Introduction and Executive Summary

COVID-19 triggered a historic collapse in peacetime economic activity. Every indicator continues to point to a multiyear crisis with long-lasting repercussions. School closures will disrupt the lives and prospects of seven out of ten children worldwide. With extreme poverty, hunger, and deprivation rising for the first time in decades around the world, as many as 100 million more people could be living on less than US\$1.90 a day in the wake of the pandemic. Global trade is on track to shrink by 10 percent in 2020, and will take years to recover to pre-pandemic levels. After driving global growth for two decades, an unprecedented nine out of ten emerging market economies are slated to contract. Among the most vulnerable countries, rising debts had already threatened funding for development priorities such as public health on the eve of the pandemic. *A lost decade of growth in large parts of the world remains a plausible prospect absent urgent, concerted, and sustained policy response.*

Fundamental uncertainty about the path of the pandemic and its economic fallout, and differences among countries, can complicate policy choices and multilateral efforts to coalesce behind a decisive action program. Initial public health damage from COVID-19 is less severe, on average, than originally expected in low- and middle-income countries, but the average is misleading. Latin America has seen some of the highest infection and death rates per capita. India's cases are surging rapidly. Small island economies are fighting pandemic and multiple climate shocks, hemorrhaging financial flows and tourism revenues. The combined public health and economic crisis has been devastating for South Africa, where it has hit the Black majority population especially hard, aggravating already extreme inequality.

Some sovereigns, most of them investment-grade, were able to borrow in the international capital markets since February of 2020, but an unprecedented number of countries saw ratings downgrades. *No Sub-Saharan African country has borrowed in the international capital markets since February 2020.*

We reject the view that the worst of the crisis has passed. It reflects a failure to recognize continuing public health, economic, and political risks, and undermines the global response. *Remaining uncertainty must not become an excuse for inaction.*

Advanced economies have responded to uncertainty with domestic measures that match our assessment of the gravity of this crisis. Governments there have found innovative ways to expand central bank balance sheets and run double-digit budget deficits, established multi-trillion dollar facilities to bolster market liquidity and credit flows, and enacted emergency measures to help cash-strapped people and firms, but only at home. *The international response to COVID-19 in middle- and low-income countries pales by comparison to the domestic policy response in advanced economies. It has been unambitious, uncoordinated, and uneven.*

Existing crisis management and debt restructuring institutions are an increasingly poor fit for today's mix of actors and problems. New creditors—bond holders, China's policy banks, hybrid and commercial actors—represent the bulk of debt payments from low-income countries in the wake of the pandemic shock. Adapting the international financial architecture to these and other new stakeholders will take time. *Urgent responses to the pandemic cannot wait for this process to run its course, but must be mindful of the need to build trust for sustained cooperation in this crisis and beyond.*

“No Sub-Saharan African country has borrowed in the international capital markets since February 2020.”

It is more important than ever for all official, commercial, and hybrid creditors, public and private, to coordinate among themselves to achieve sufficient relief and transparently equitable burden sharing, or comparability of treatment. *Any effort to manage a multi-year crisis that spans large parts of the globe would fail if any country’s citizens become convinced that they were subsidizing repayments to other creditors instead of pandemic response.*

Today’s historically low interest rates reduce the cost of debt relief for the creditors. This presents a rare opportunity to bolster the sustainability and resilience of emerging market debt to future shocks, and to experiment with new market and policy tools to meet upcoming challenges. Traditionally compelling arguments against tackling debt problems early are attenuated in a pandemic. *Vulnerable countries’ policies did not cause the COVID-19 shock, and their governments cannot manage the response to it on their own.*

There is no silver bullet against the pandemic crisis, and one-size-fits-all solutions are unlikely to work for today’s diverse group of borrowers and creditors. In the preliminary report that follows, the G30 Working Group has identified seven areas that require urgent policy action. These areas will be the focus of its work for the remainder of the year, with a view to releasing a final report early in 2021. *At this preliminary stage, we have reached consensus on the following recommendations in each of the seven areas:*

1. *The International Monetary Fund (IMF) should mobilize global liquidity on a larger scale than ever before in the face of uncertainty, scale up its crisis lending in low-income countries, and use far more of its existing non-concessional resources to mitigate economic fallout from COVID-19. IMF members should commit to two new \$500 billion Special Drawing Rights (SDR) allocations to boost global reserves. In the meantime, they should reach agreement to reallocate a portion of existing SDR to those hardest hit by pandemic-related balance of payments shocks. The IMF must be equipped*

to respond to large-scale outflows from multiple low-income countries at the same time, and needs to double its concessional financing capacity to that end. It can and should use its existing resources to double non-concessional lending, to help middle-income countries manage the crisis.

2. *The World Bank Group and the growing array of regional development banks have a critical role to play in preventing the COVID-19 shock from turning into a global humanitarian crisis, fueling inequality and social strife. They need to find creative ways to maximize their concessional “surge” capacity as part of a coherent multilateral framework, avoiding duplication. The World Bank should recalibrate prudential limits on its lending, and seek new donor funds for a temporary increase in grants to ensure that adequate concessional resources are on hand when needed.*
3. *A return to private capital markets is a worthy objective for countries, both now and after the pandemic has subsided. The Principles for Stable Capital Flows and Fair Debt Restructuring have served as a valuable framework for best practices in debt management, notably including debt transparency, that help underpin market access. Nonetheless, the perceived imperative of maintaining market access has served at times as an excuse to deny economic reality and not deal with a debt overhang. This crisis also highlights a tension between commitments to voluntary debt restructuring and fair treatment of all creditors. We recognize that when voluntary negotiations fail to achieve comparability and reduce debt overhang, more robust legal measures—such as those outlined in the September 2020 IMF report for the G-20—may be needed to shield borrowers temporarily from disruptive enforcement as they take part in multilateral debt initiatives.*
4. *China’s new prominence as a creditor calls for it to take a more active role in multilateral crisis resolution, recognizing the distinct institutional features of its lenders. Other new lenders may follow its example going forward. Whether China decides to join the Paris Club, to pursue a complementary forum for some or all*

of its lenders, or both, we remain convinced of the need to reinforce the long-standing international comparability norm, which gives all creditors ample flexibility in structuring their participation, including by contributing new money on sustainable terms.

5. Inadequate sovereign debt and debt restructuring disclosure results in a faulty patchwork of information about direct and contingent claims against sovereigns. Sovereign borrowers should include robust disclosure requirements as part of public debt authorization, including guarantees and other forms of engaging the credit of the central government. Undisclosed, unauthorized debt would be hard to enforce in major financial jurisdictions. Disclosure and authorization criteria should be clear and well-publicized to put creditors on notice that secret debts may not be enforced.
6. Sovereign borrowers should adopt, and official creditors should promote, greater use of maturity extension options and simple interest capitalization, consistent with recent market proposals. In addition to provisions that work within the basic structure of the bond market, there is ample scope for more equity-like options, such as commodity-indexed features, to help address known sources of volatility. International financial institutions and official bilateral creditors should use contingency features in their own lending, and should consider ways to use official support to promote instruments that provide concessional financing, such as full or partial

“Whether China decides to join the Paris Club, to pursue a complementary forum for some or all of its lenders, or both, we remain convinced of the need to reinforce the long-standing international comparability norm.”

interest forgiveness, in the event of a verified common shock, such as this pandemic. More contingent features enable countries to sustain a higher level of debt.

7. A large number of sovereign borrowers have been downgraded since the start of the pandemic. Since the start of the pandemic, fears of an automatic downgrade have made some countries reluctant to seek debt relief, even when they may need it. The pro-cyclicality of ratings actions and the risk of contagion in the wake of a downgrade are also a concern for a subset of countries. Mindful of financial stability risks, policy, regulatory, and market institutions should minimize obstacles to recognizing and dealing with debt problems.

The final report will elaborate on these preliminary recommendations, provide additional data and detail, and address what are likely to be consequential developments in the coming months.

1. Boosting Global Reserves and Rationalizing IMF Financing Capacity

We call on IMF members to commit to two new SDR \$500 billion allocations that could be implemented rapidly in response to future shocks or serious economic deterioration. Separately, IMF members should agree on a mechanism for re-allocating existing SDR to the most vulnerable among them. The Fund needs to double its concessional lending capacity, exhausted early in this crisis, to enable it to respond nimbly to large-scale outflows in multiple vulnerable countries. It should signal willingness to use far more of its ample non-concessional resources to support middle-income countries in the face of uncertainty.

Emerging market economies face a massive balance-of-payments shock from the pandemic: trade revenues, remittances, international tourism, and foreign direct investment flows are collapsing at the same time. The combined effect of these shocks in low-income countries alone could plausibly reach US\$150 billion in 2020, and US\$100 billion more in 2021. The IMF has most of the tools needed to respond to a shock even of this magnitude, including its unique ability to expand global reserves by issuing Special Drawing Rights (SDR) and its trillion-dollar non-concessional lending capacity, but has yet to use them fully.

The G-20 and the IMF demonstrated global solidarity in the face of the global financial crisis in the fall of 2009 by revitalizing SDR, the international reserve asset envisioned in the late 1960s as a way for the IMF to supplement gold and hard currency reserves. An unprecedented allocation

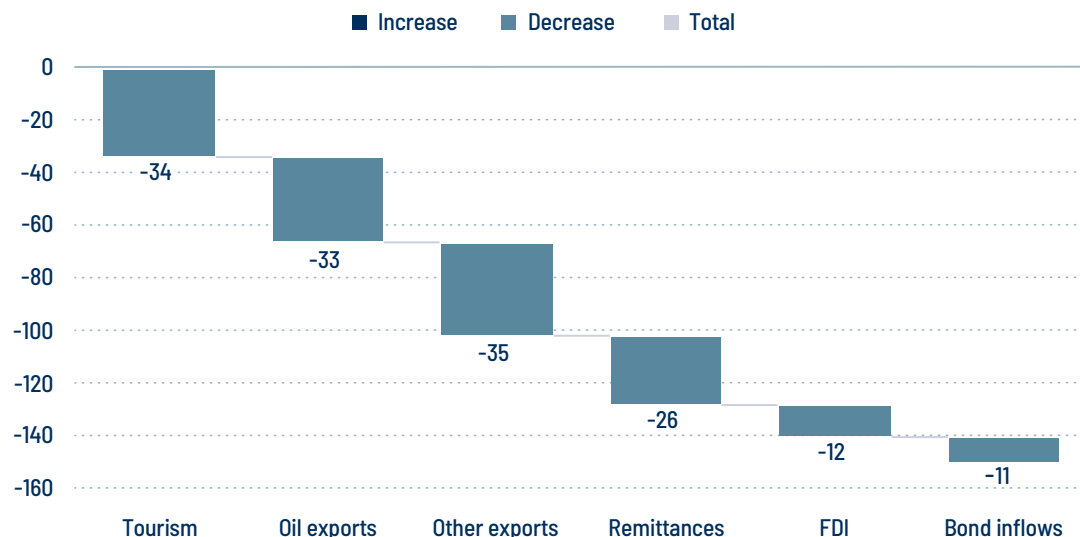
of SDR 250 billion agreed at the G-20 summit in London demonstrated global solidarity in the face of the crisis.¹

Most of the SDR 250 billion allocated in 2009 sits idle in the accounts of advanced economies. Because new SDR are allocated according to members' IMF quota shares, the bulk of any new allocation goes to advanced economies, which do not rely on SDR to manage balance-of-payments pressures. A member may lend its SDR or exchange them for other currencies, which it can use or sell as it pleases. Countries with no pressing need for SDR could pool and lend them to vulnerable economies, delivering a significant reserve boost where it was needed the most, and where it would have the biggest impact on the global economy. Pooling and reallocation have broad-based support in the international community. In a pandemic crisis projected to do far more damage worldwide than the

¹ A new SDR allocation does not require new resources from IMF members. An IMF member's allocation is recorded in its SDR account at the IMF, and effectively raises its reserves in perpetuity. The country receives the IMF's SDR interest rates on its SDR balance, and pays the SDR interest rate back to the IMF. If it exchanges its SDR for dollars and sells the dollars in the market, it would still owe the SDR interest rate, but, at 10 basis points, an SDR allocation is an extremely low-cost source of reserves in the current environment.

FIGURE 1

\$150 billion expected fall in exports, remittances, and investments in IDA (low-income) countries in 2020



global financial crisis did a decade ago, faced with evidence of looming reserve shortages in some emerging market economies, reaching agreement on the mechanism should be straightforward.

A simple reallocation mechanism, such as the one described in a 2018 IMF staff paper, would be consistent with the IMF Articles of Agreement and would require modest additional legislative action on the part of the members. Countries with limited reserve needs and strong existing reserve positions could pool their SDR contributions in a trust, similar to that used for the IMF's Poverty Reduction and Growth Trust, or an IMF-administered account. The IMF as administrator would on-lend the SDR to the poorest countries in perpetuity, or for a limited term, as agreed with the donors. Such an arrangement could be put in place quickly, and would not require individual bilateral negotiations with donor and recipient countries. The size of any reallocated pool can vary, and would depend in part on the size of any new SDR allocation.

Reallocation alone would not be enough to contain likely economic damage from the pandemic. Agreement on staged allocations of new SDR would help make the global economy more resilient in the face of continued uncertainty. Two new allocations of SDR \$500 billion each would serve as a meaningful cushion against new shocks and would promote vital multilateral cooperation. The first allocation

could be implemented rapidly, as most countries have already expressed support, and would not require additional authorization from the U.S. Congress.² Preparation for the second round, including legislative approvals where they are needed, should begin immediately to signal global commitment.

An SDR allocation would be more effective and more equitably distributed than other multilateral initiatives to help vulnerable countries fight the pandemic, but would not be sufficient by itself to meet their financing needs. One SDR \$500 billion allocation could immediately deliver over US\$150 billion in additional reserves to potentially vulnerable emerging market economies, including US\$20 billion to low-income countries directly. Although the advanced economies would still be the largest recipients of SDR under the IMF Articles of Agreement, the amount provided to the poorest countries would be a multiple of the funds freed up by the G-20 Debt Service Suspension Initiative (DSSI), and would be far more

“Two new allocations of SDR \$500 billion each would serve as a meaningful cushion against new shocks and would promote vital multilateral cooperation.”

² A new SDR allocation of under \$650 billion requires notification to the U.S. Congress.

broadly distributed among them (see Part 3). Nonetheless, a single SDR allocation, even if paired with a substantial reallocation of existing and new SDR, would only cover a portion of low-income countries' balance-of-payments gaps.

The return of “uphill” capital flows at a time when interest rates in the advanced economies are low is among the more pernicious consequences of the COVID-19 shock. Additional resources from the SDR allocation for emerging market economies, even those with no immediate reserve pressures, would strengthen their liquidity position and reduce the impetus for private capital to flow to advanced economies in the face of pandemic-driven uncertainty. This would make emerging market economies more resilient against this and future shocks.

The best way to manage equity and sustainability concerns potentially associated with an SDR allocation is to condition all forms of official support on restructuring unsustainable debt. New SDR allocation is unconditional. Countries with unsustainable debt may choose to sell SDR for foreign exchange to repay existing creditors, instead of meeting pandemic-driven balance-of-payments and liquidity needs. SDR reallocation through a trust fund structure could pair an infusion of additional reserves with a rescheduling of existing claims on those low-income countries in or at risk of debt distress, as judged

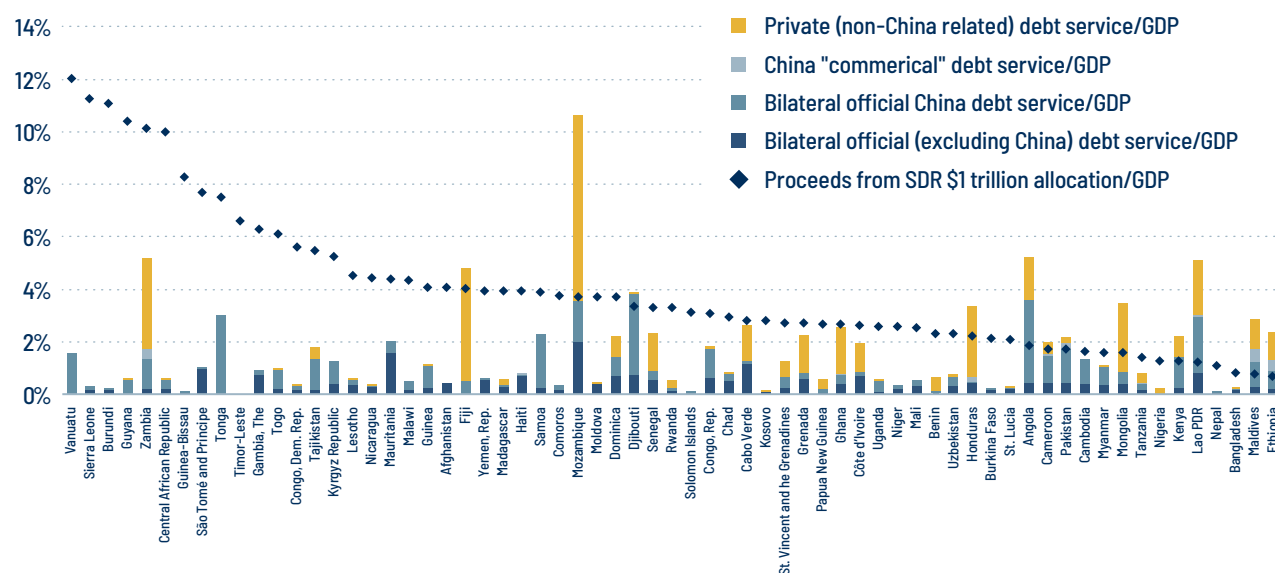
to have vulnerable debt positions by the IMF and World Bank. However, conditionality in this context should be assessed against the background of global conditions and the country's need for liquidity at the time. In general, IMF lending programs are a better vehicle to implement debt sustainability and other policy conditions.

In response to COVID-19, the IMF quickly mobilized and almost immediately exhausted its concessional lending capacity, which was not designed for a global shock of this magnitude or for countries prone to large-scale capital outflows. At the start of the crisis, the IMF increased disbursements to low-income countries through its concessional Rapid Credit Facility (RCF), and covered payments on existing IMF loans to the poorest low-income countries through the Catastrophe Containment and Relief Trust. The RCF provides low-income countries with zero interest rate loans, and can deliver immediate balance-of-payments and budget support. It is designed to support a steady-state lending capacity between US\$1.5 billion and US\$2 billion a year, not for widespread shocks and large-scale outflows.

Although expanding RCF lending capacity would require a commitment of donor resources, the cost of IMF lending to the donors is very modest in today's interest rate environment. Temporarily doubling the size

FIGURE 2

Based on their 2020 debt stock, GDP, and IMF quotas, most DSSI-eligible countries benefit more from SDR \$1 trillion allocation than from the DSSI (Bhutan, Liberia, and Somalia excluded for data scale reasons)



Note: DSSI = Debt Service Suspension Initiative.

of the RCF for the duration of this crisis, with a sunset date and a limited option to extend, would be an efficient way to target concessional resources. The RCF funding model, where donors cover the cost of zero interest rate concessional loans, is easily replicable. It should be considered for other multilateral lenders, as a simple way to transform non-concessional into highly concessional financing. Low global interest rates limit the cost of any interest rate subsidy to the donors. Here too, trust fund structures would be a simple and accountable way to manage the resource flow.

The IMF's non-concessional capacity remains underutilized, in contrast to its concessional resources. The IMF has US\$650 billion in quota resources, US\$250 billion from the New Arrangement to Borrow (NAB), and access to an additional US\$400 billion from standing bilateral credit lines in the near term. The NAB is slated to double in size at the end of 2020, alongside a corresponding reduction in the standing bilateral borrowing lines. Maintaining bilateral lines at US\$400 billion after the NAB expansion would assure that the IMF retains a lending capacity of approximately US\$1 trillion, after taking into account existing commitments and the need for a prudential buffer.

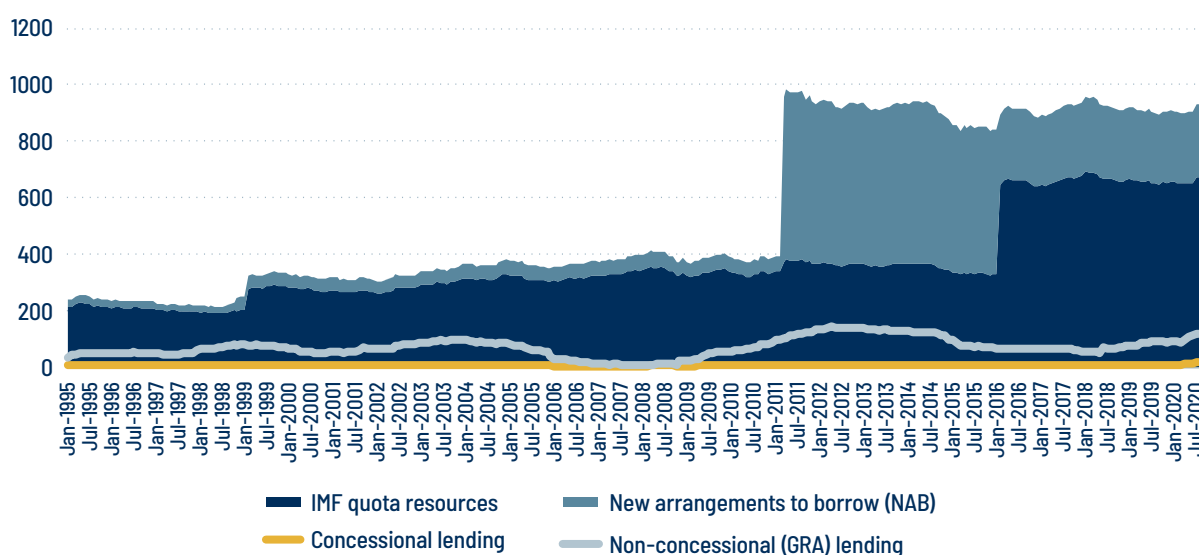
The IMF has disbursed only US\$30 billion in non-concessional funds since the start of the pandemic, less than one-third of its US\$100 billion envelope for pandemic-related financing through the Rapid Financing Instrument (RFI) in 2020. Disbursements

have been limited despite expanding its rapid disaster lending window to 100 percent of quota and adding precautionary lines of credit to backstop market access for emerging economies with relatively strong external positions. While not all eligible countries have opted to use the RFI, some large emerging market economies have, including South Africa. The RFI is a low-conditionality instrument, and lacks the stigma of a traditional IMF program.

COVID-19 is a multiyear shock and requires extraordinary financing tools that could last beyond one year. The IMF has scope to double the upper limit of support offered through the RFI, by increasing the cumulative limit to 200 percent of quota and making another 100 percent of quota, or US\$100 billion, available in 2021.

After these increases, the IMF would still retain over US\$500 billion in lending capacity, which is ample to protect against an unexpected future shock. Such a buffer remains vital in a world where most emerging markets will exit from the pandemic with large public debt stocks and in some cases depleted external reserves. While the increase in the public debt of emerging economies is generally more modest than that in advanced economies, overall debt levels will rise. In some cases, they have already reached levels that raise future concerns. Both Brazil and South Africa, for example, are on trajectories to increase their public debt-to-GDP ratio to over 100 percent.

FIGURE 3
IMF lending compared to the IMF's committed resources, US\$ billion



2. Concessional Surge Capacity in Multilateral Development Banks

The World Bank Group and the growing array of regional development banks are the international community's leading tool to fight poverty and inequality. They have the instruments and the outlook to help prevent the shock from COVID-19 from turning into a global humanitarian crisis and to reverse the damage in its aftermath. In response to the pandemic, the World Bank Group should, at a minimum, double its rapid concessional lending capacity by accounting for more of its capital base. We support a prudent expansion of International Development Association borrowing at current low interest rates. Additional donor funds can support a temporary increase in grants. Regional development banks should consider creative ways to maximize their surge capacity in a coherent multilateral framework, avoiding duplication.

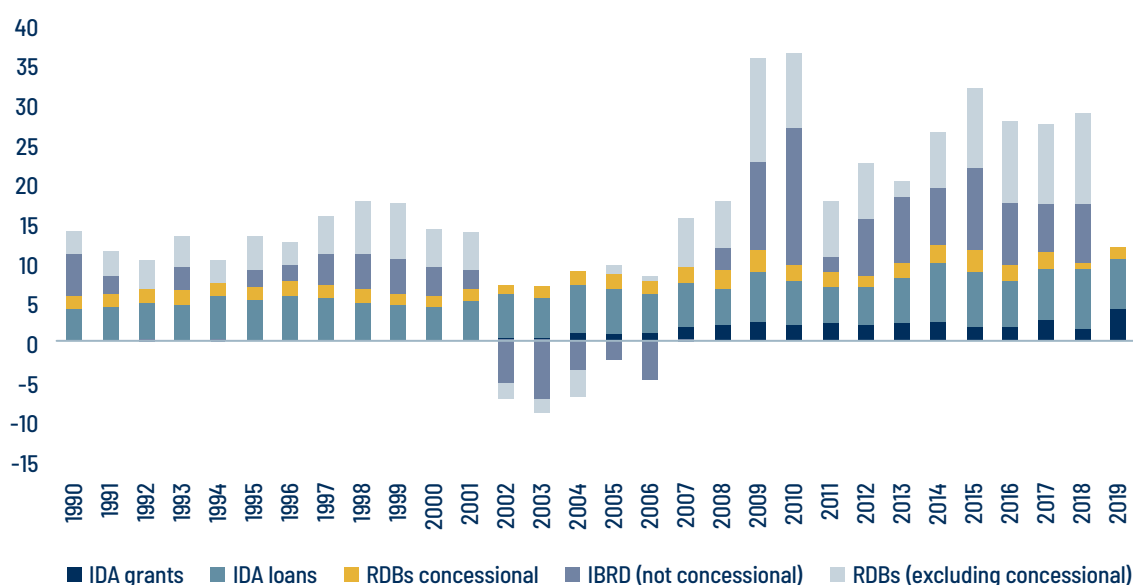
International financial institutions lack capacity to scale up concessional financing in the event of a global shock. The International Development Association (IDA), the concessional lending part of the World Bank Group, lacks “surge” capacity. Across the multilateral system, global and regional institutions that lend on concessional terms are designed to disburse gradually to meet long-term development needs, not massive exogenous shocks affecting nearly every borrowing country. This architecture limits the world’s ability to respond effectively to a global pandemic that has strained the financial and budgetary resources in many of the world’s poorest and most vulnerable countries.

A wide and growing array of regional development banks bring different mandates, perspectives, funding sources and expertise to the task of managing the pandemic and its aftermath. Established and new institutions

“International financial institutions lack capacity to scale up concessional financing in the event of a global shock. The International Development Association (IDA), the concessional lending part of the World Bank Group, lacks “surge” capacity.”

will need to use their comparative advantage to marshal resources, including new concessional funds, to minimize the humanitarian and economic costs of the crisis. Effective intervention will entail creative use of new instruments in the face of unprecedented financing needs and historic

FIGURE 4

Net financial flows for for LICs and Sub-Saharan Africa, World Development Indicators (US\$ billions)

Note: IBRD = International Bank for Reconstruction and Development.

uncertainty. To maximize their collective impact and avoid duplication, these diverse institutions should share information and collaborate in crisis to ensure that their respective contributions are additional and complementary.

We anticipate a recurring need for surge capacity to manage public health, climate, and financial shocks. Mobilizing funds quickly is essential to limit the impact of the pandemic on public health and to mitigate the impact of the shock on the poorest people. Spending needs have grown, including essential income support for those who have lost jobs, while tax revenues have fallen. Multilateral development banks can help meet emergency needs, using their traditional direct budget support instruments to finance programs to reduce poverty and inequality, including direct cash transfers.

Since the global financial crisis, the World Bank and regional development banks doubled their total lending, but have only marginally increased their concessional grant financing. Building on their experience with delivering large-scale countercyclical financing to vulnerable countries, multilateral bank shareholders should temporarily expand concessional financing by these institutions in light of the exceptional scale and incidence of the COVID-19 crisis. Any such expansion should not come at the expense of non-concessional flows, which must be

maintained or increased to help protect vulnerable middle-income countries. For the World Bank Group, it will involve a combination of leveraging the existing capital base, less conservative accounting for the role of callable capital, and new donor resources.

Poor policy choices in low- and middle-income countries did not cause this unprecedented shock, which threatens hard-won development gains in health, education, fighting hunger, and inequality. Helping the most vulnerable in this context is a cost-effective way to help the global economy, and is the right thing to do.

Humanitarian and economic fallout from COVID-19 threatens IDA's ability to maintain its financing at the level projected in its most recent replenishment, concluded as the pandemic took hold in the spring of 2020. IDA provides a mix of grant and loan financing to the world's poorest countries from a combination of donor resources, including US\$27 billion over three years in its latest replenishment, agreed in the spring of 2020, the repayment of past concessional loans, contributions from other parts of the World Bank Group, and most recently, modest capital market borrowing. The latest replenishment was designed to maintain IDA's annual net new financing capacity at US\$15 billion a year for three years, similar to the preceding replenishment.

Front-loading emergency lending reduces future lending capacity in a prolonged crisis.³

IDA donors and the World Bank should commit an additional US\$50 billion to the resources available to IDA in the current three-year replenishment window, to support an “all of the above” strategy—a higher share of grants to limit future debt vulnerability and more concessional lending to maintain higher overall levels of net financial flows. Such a commitment would raise the net grant and loan flow to low-income countries from US\$15 billion to above US\$30 billion a year. It should include an additional US\$15 billion in donor commitments to finance grants, while leveraging IDA’s large existing equity base (IDA’s US\$160 billion equity is about equal to its stock of outstanding loans) to support an additional US\$35 billion in market borrowing. Persistently low interest rates make concessional lending financed through market borrowing exceptionally cost-effective. Total net concessional flows to low- and middle-income countries would double to address the shock of the pandemic.

The precise allocation of surge capacity to deal with exogenous shocks among the World Bank Group and regional institutions will vary from crisis to crisis. Pooling multilateral resources in certain cases can help make the system

more resilient. Individual institutions’ financial structures, mandates, and governance arrangements differ, as do their respective capital positions and lending portfolios. Regional development banks as a group do less concessional lending as a share of total lending than the World Bank Group. Non-concessional multilateral lending (at market-based interest rates of less than 3 percent, based on the lenders’ cost of funds, combined with very long-repayment terms) poses substantially fewer risks to vulnerable countries than market borrowing in the current context.

Urgent and large-scale multilateral support is the best chance for the international community to mitigate the outsized impact of the shock on the poorest and most vulnerable, and its long-term consequences fueling inequality and strife. Advanced economies have used their ability to borrow at low rates to limit the economic and humanitarian impact of the pandemic at home. Low- and middle-income countries do not have the tools or the resources for comparable stimulus programs. They have little room to expand budget deficits, and limited scope for market borrowing. The multilateral and regional development bank system is a vehicle established by governments to do the same internationally.

3 IDA grants use more donor funding than IDA loans. As more countries face debt distress, IDA policy would require it to shift from concessional loans to grants. To finance more grants, IDA would have to scale back commitments or risk raising its borrowing costs by dipping into its equity base, which stands at approximately US\$160 billion, the same as its outstanding loans.

3. Private Capital Market Access, Debt Overhang, and Comparability of Treatment

Stable access to the private capital markets is a sound policy objective. The Principles for Stable Capital Flows and Fair Debt Restructuring have served as a valuable framework for best practices in debt management, including valuable recent initiatives in debt transparency, which help underpin market access. Nonetheless the desire to retain market access at all costs cannot be an excuse to deny economic reality and address delaying a debt overhang, nor facilitate the exit of private capital without burden sharing with public funds. Both the public and private sectors need to play a constructive role in addressing the economic and social costs of the pandemic. This crisis highlights a tension between commitments to voluntary debt restructuring and to inter-creditor equity, or comparability of treatment. We recognize that more robust measures, such as those described in the September 2020 IMF report for the G-20, may be necessary if voluntary negotiations fail to achieve comparability and deal with debt distress.

The desire to return to the international capital markets should provide the impetus for countries that suffer from debt overhang to deal with it promptly and effectively.

Sustained net positive private capital flows to emerging market economies are essential for poverty reduction, development, and global growth. The COVID-19 shock triggered capital outflows from emerging market economies of more than US\$80 billion at the start of the pandemic. We support the goal, expressed by many emerging market governments, of returning to the private capital markets. However, when countries use dwindling revenues and foreign currency reserves to pay debt instead of to pay for

urgent public health and humanitarian priorities, they are likely to harm their market prospects in the medium and long term. In some cases, a temporary debt service pause or a debt restructuring may be a necessary precondition for returning to growth and the eventual resumption of market financing on sustainable terms.

A number of countries were on an unsustainable trajectory even prior to the pandemic, with debt rising faster than their payment capacity. The external debt of Sub-Saharan Africa, many Latin American countries and IDA-eligible countries in Asia was already on track to double between 2010 and 2020.

FIGURE 5

New creditors displacing the Paris Club World Bank data, stock outstanding (US\$ billions)

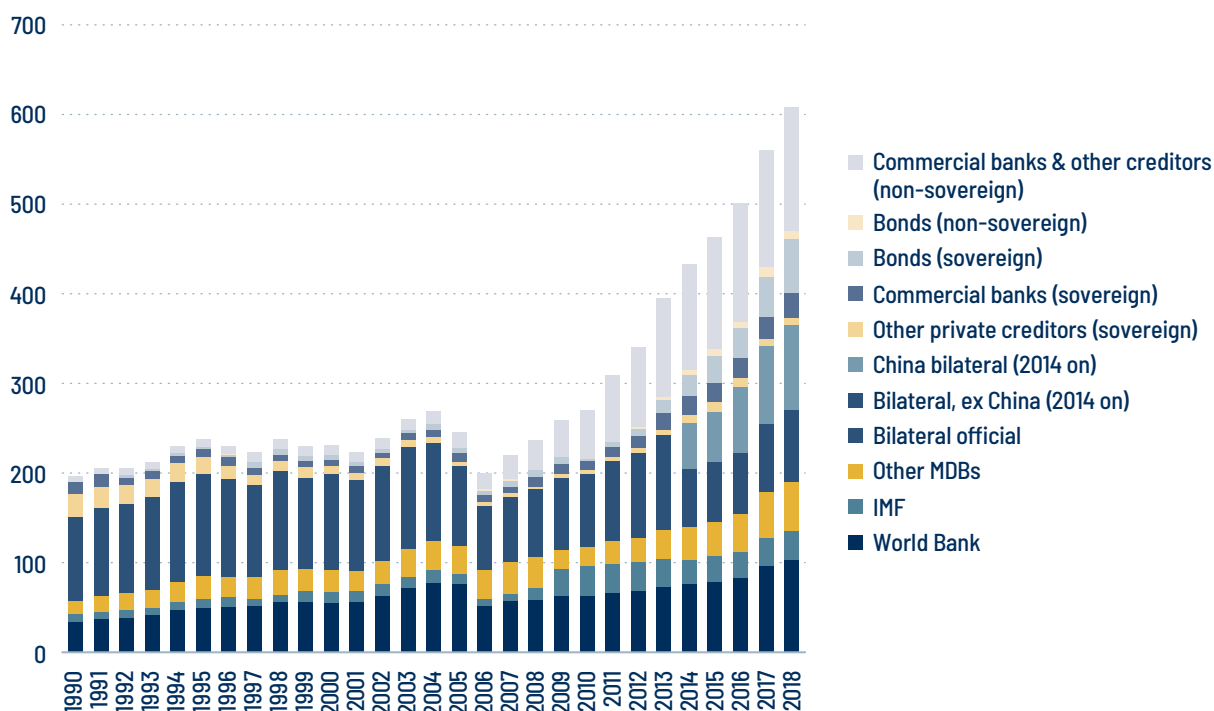
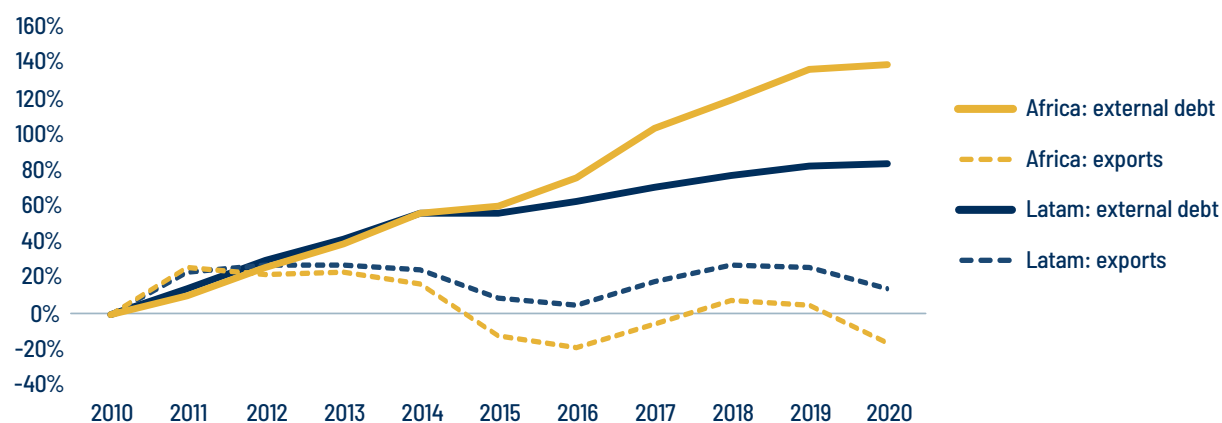


FIGURE 6

External debt up, exports of goods and services down percent change from 2010 (2020 is a forecast)



Since 2015, external debt in both Africa and Latin America has increased faster than exports and living standards

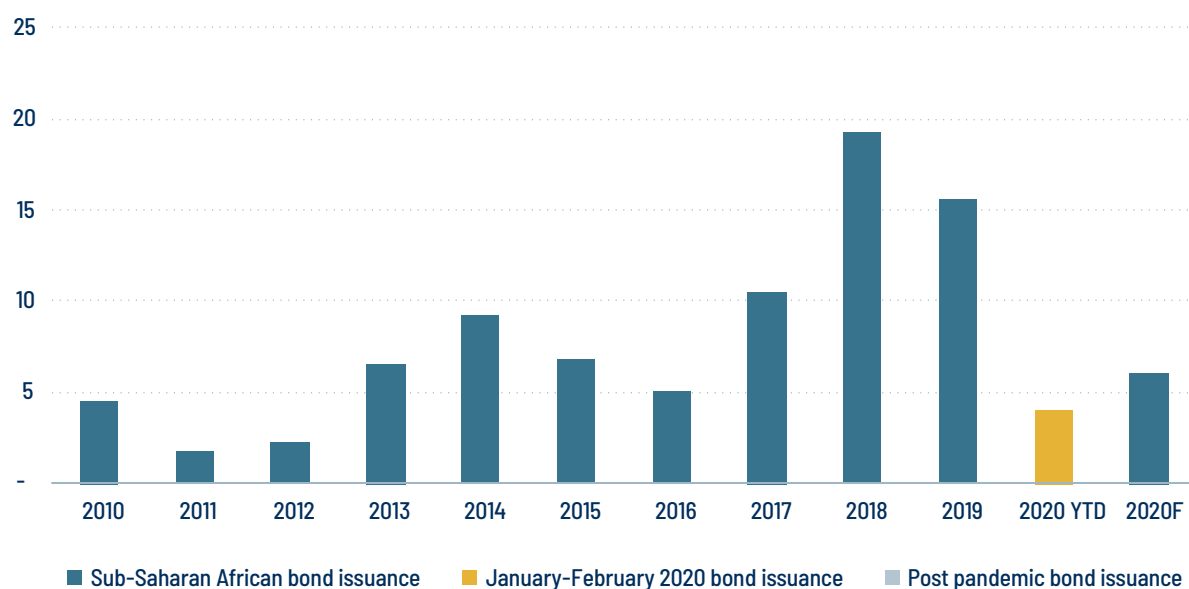
While there is substantial variation across countries, total interest payments, a key measure of the debt burden, have increased rapidly. Interest payments on the external debt of Sub-Saharan African countries, for example, are poised to rise from less than half of one percent of regional GDP in 2010 to over 1.5 percent in 2020, levels not seen since the Heavily Indebted Poor Countries (HIPC) initiative at the turn of the century. Research from Moody's, among others, shows that a rapidly rising debt burden is a more important indicator of future debt distress than a high debt stock on its own.

Although some countries have tapped the international capital markets since March, sovereign issuance has concentrated in the shrinking set of investment grade sovereigns. Reports that focus on foreign currency bond issuance by high-quality investment grade sovereigns since the start of the pandemic paint with a broad brush, and overstate the case for the return of market access for emerging market economies. Notwithstanding large dollar-denominated issuances from Abu Dhabi and Dubai, as well as from Brazil, Egypt, and Indonesia, among others,

investors who left local currency markets in March have not returned. The return to market access has notably excluded Sub-Saharan Africa entirely.

Not all countries at risk of debt distress are low income, and not all low-income countries are overindebted. Debt stocks, debt composition, debt service profiles, and country circumstances differ widely. Some middle-income countries were in or on the brink of a crisis in late 2019, including Argentina and Ecuador, which have since restructured their international bonds (see Box 1). Others, such as Venezuela and Lebanon, remain in deep distress. Some low-income countries, such as Zambia, have engaged with their creditors since the start of the pandemic to eliminate an obvious debt overhang, but other overindebted countries, such as Angola, have not. Low-income countries that are not clearly overindebted may still struggle to meet their near- and medium-term obligations, and would need to defer payments to gain budget flexibility to manage the crisis. Such payment deferrals should be mindful not to add to existing payment spikes, as there are already large maturities for many countries in 2024 and 2025. Yet other low-income countries, such as Côte d'Ivoire, have modest external debt but still need urgent help to manage the crisis. A one-size-fits-all approach would not work.

FIGURE 7
Sub-Saharan African bond issuance (US\$ billions)



Source: J.P. Morgan, Bloomberg

BOX 1

Collective Action Clauses and Bond Restructuring Experience

Newly completed restructurings in Ecuador and Argentina mark the first use of the latest model of aggregated Collective Action Clauses (CACs) developed by market participants, in collaboration with sovereign borrowers and official creditors, and endorsed by the G-20 and the IMF in 2014. Both bond exchanges were completed within months, faster than in the past.

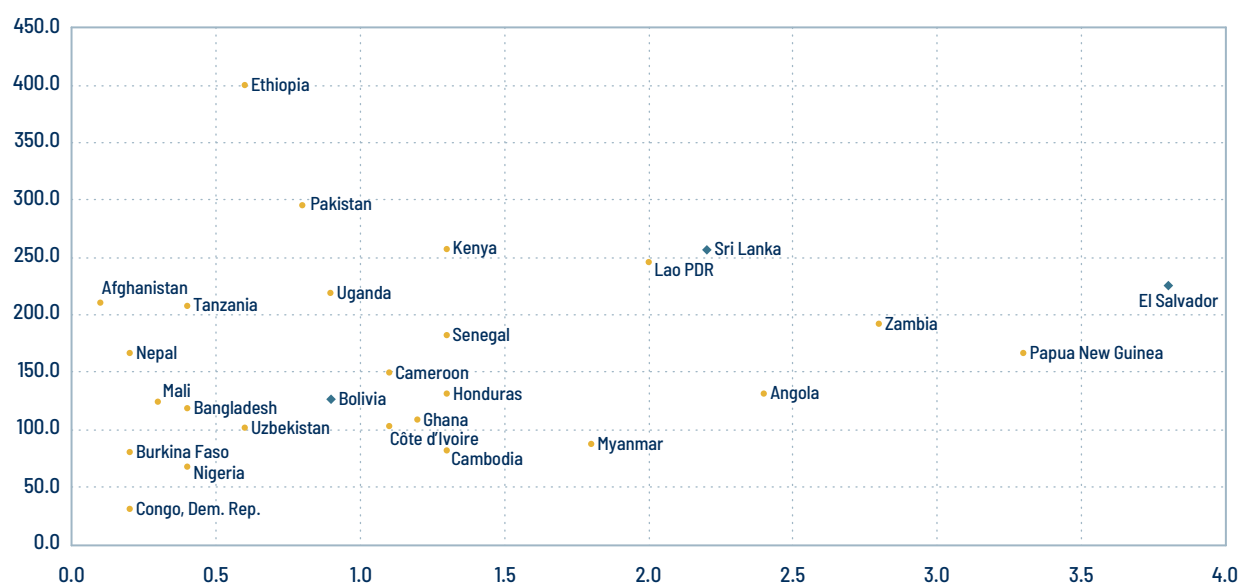
Ecuador secured a voluntary payment suspension from its creditors while it restructured. A U.S. federal court challenge to some of its restructuring tactics was quickly dismissed and did not delay the closing. Argentina revised its offer three times and briefly went into payment default, but no creditor accelerated or sued. Both countries initially sought to use CACs in ways that proved controversial with creditors, but made contract changes going forward to balance the need for flexibility with safeguards against abuse.

Whether the economic outcome is sustainable will depend on government policy, global macro-economic prospects, and the course of the pandemic. The lesson from the test case so far, as noted in the September 2020 IMF paper on debt restructuring architecture for the G-20 is that CACs remain a useful market-based restructuring tool.

We support continued monitoring by IMF staff and periodic review and revision of the market standard, as necessary, by key stakeholders. The next review should consider revising the current version of the aggregated voting mechanism to support maturity extension (reprofiling).

FIGURE 8

External Debt Stocks/Exports of Goods, Services & Income (%) (2017–2018) Compared to Interest Payments on External Debt/GNI 2018 for the 25 Biggest Economies Eligible for DSSI (by GDP) Plus Selected Middle Income Countries



Crisis response and implementation experience so far with the Debt Service Suspension Initiative (DSSI) has revealed design flaws that would make it ill-suited as a platform for addressing the debt problems of countries at risk of debt distress in this pandemic crisis. DSSI represents an early and important recognition of the immediate cash flow pressures on some low-income countries; however, it has delivered far less relief than originally envisioned, and was both over- and under-inclusive in its eligibility criteria. DSSI benefits are moreover concentrated in a small handful of countries, with almost half of the original initiative going to just two countries, Pakistan and Angola.

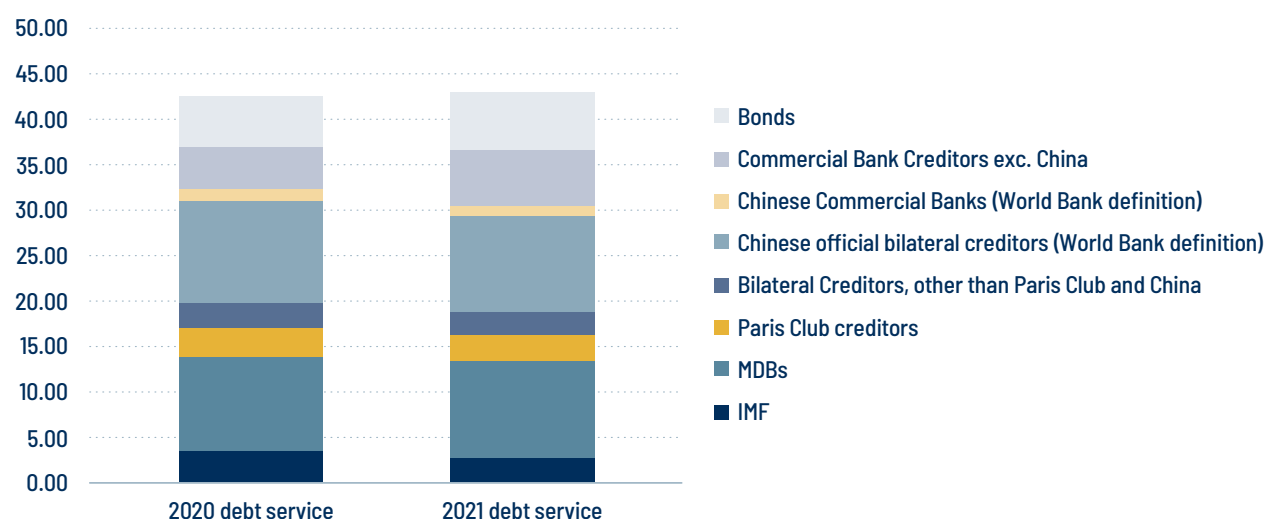
DSSI is on track to deliver US\$5 billion in debt flow relief to 43 countries in 2020, out of more than US\$12 billion initially projected. The expected total had included payments to state-owned development institutions that loaned at relatively high market based commercial interest rates, and have so far declined to participate in the initiative. In addition, the initiative contemplated comparable treatment of commercial claims, which has not materialized. The onus of requesting relief was on sovereign borrowers, who chose to forgo the brief debt service reprieve in hope of preserving market access. Failure to involve all relevant government creditors in DSSI and to secure private sector payment deferral on comparable terms, has meant that a significant share of cash flows deferred by participating official creditors went to service debt to non-participating creditors.

Eligibility based on national income levels has meant that countries with significant debt vulnerabilities are excluded from DSSI, while low-income countries with little debt receive few benefits. Expanding eligibility to heavily indebted countries just above the original income cut-off, such as Sri Lanka, or more broadly to countries with significant debt burdens and at risk of debt distress, would help limit some of the economic damage from the pandemic crisis. On the other hand, low-income countries that have little debt need access to new concessional financing to manage the budget cost of fighting the pandemic.

The duration and scope of DSSI as originally designed are similarly inadequate, and should be expanded. While we agree with calls to extend DSSI beyond 2020, a one-year extension is unlikely to be enough. Moreover, capitalizing interest payments at non-concessional rates would

“Capitalizing interest payments at non-concessional rates would leave many countries with higher debt stocks than they had before the pandemic, and would not deal with existing debt overhang in an important subset of countries.”

FIGURE 9
Debt Service of DSSI countries, USD billion



leave many countries with higher debt stocks than they had before the pandemic, and would not deal with existing debt overhang in an important subset of countries. An expanded DSSI should include the possibility of interest forgiveness where debt sustainability is in question, and debt reduction where debt is unsustainable. Judgments about appropriate relief should be made case by case but—given the scale of the shock and the low cost of debt relief in the current economic environment—the presumption should be in favor of more relief.

Failure to secure the participation of all creditors, including private, commercial, hybrid, and state-owned lenders, would undermine political support for a concerted global response to the crisis, and diminish the appetite for official co-financing in the future. Foreign sovereign bonds account for approximately 12 percent of the identified public external debt of DSSI-eligible countries, but these commercial claims carry a high interest rate, and would account for nearly a third of total interest payments in 2020 and 2021. The claims of China’s development institutions and policy banks account for a higher share of near-term payments. With approximately 20 percent of the identified overall debt stock, these creditors account for 25 percent of interest payments and close to 30 percent of all identified 2021 debt service. The total claims on sovereign governments are likely to be higher, because they would include projects with debt service likely to turn into claims on the sovereign. Without full creditor participation, official debt relief would not achieve its purpose of supporting a pandemic response.

The Principles for Stable Capital Flows and Fair Debt Restructuring have played an important and constructive role in promoting debtor-creditor engagement and formulating best practices in debt management since 2004. We recognized transparency and the timely flow of information, fair and comparable treatment of all creditors,

“Failure to secure the participation of all creditors, including private, commercial, hybrid, and state-owned lenders, would undermine political support for a concerted global response to the crisis.”

and voluntary debt restructuring as key factors for establishing and maintaining market access, and welcomed ongoing efforts to create a public platform for disclosure of debt contract terms. It also noted that voluntary measures, implemented in good faith, may fail to achieve comparability or eliminate debt overhang. DSSI is the latest example. The history of applying the Paris Club comparability principle includes a broad range of options, including rescheduling, restructuring, and new money, available to sovereign debtors and their creditors to achieve fair treatment of all creditors. As noted in the IMF’s September 2020 paper for the G-20 on sovereign debt restructuring architecture and private creditors, more robust domestic or international legal intervention to promote inter-creditor coordination may be required if voluntary efforts fail even within such flexible parameters.

Short of such legal measures, bilateral and multilateral lenders should expressly condition their support on comparable participation of all other creditors, including bonded debt, in cases where a sovereign borrower’s debt is not clearly sustainable. Generous official support for countries in need should come with the expectation of broad-based contributions from other creditors in the form of debt service relief or new financing on sustainable terms to fight the pandemic. Making generous support conditional would create additional incentives for governments and their creditors to manage debt vulnerabilities promptly and effectively.

4. New Creditors, New Forms of Lending, a New Coordination Challenge: China's Leading Role

China's new prominence as a creditor calls for it to take a more active role in multilateral crisis resolution, recognizing the distinct institutional features of its lenders. Whether China decides to join the Paris Club, to pursue a complementary forum for some or all of its lenders, or both, we remain convinced of the need to reinforce the long-standing international comparability norm, which gives all creditors ample flexibility in structuring their participation, including by contributing new money on sustainable terms.

International financial architecture, including the informal sovereign debt restructuring regime must adapt to the rise of new creditors, such as China. Although China has engaged in overseas lending for many decades, it has since the early 2000s gradually become a leading creditor to emerging economies, and remains by far the dominant creditor in some of the most vulnerable among them. Low-income countries' outstanding debt to China's government and its state-owned lenders exceeds both bond claims and the claims of Paris Club creditors. While China's Ex-Im Bank has renegotiated some of its exposure in conjunction with DSSI, projected debt repayments to China also top repayments to traditional bilateral creditors, owing in part to market-based commercial interest rates on loans by China's policy banks.⁴ For many emerging market countries in debt distress, it would be virtually impossible to achieve sustainability without implicating

their debt to China. High concentration of exposures in a small number of countries poses an additional challenge.

China's successful integration in the informal sovereign debt restructuring regime would be an investment in the broader regime, and should help it adapt to future changes. The Chinese government and its policy banks are the most prominent of new lenders to the emerging markets owing to the reach and volume of its financing, but they are not alone. New official and hybrid creditors to Iraq, Ukraine, and Venezuela, among others, have been associated with coordination problems. New lenders typically have not participated in concerted international debt restructuring, and may not be invested in sovereign debt restructuring institutions formed before they arrived on the scene.

The Paris Club of official bilateral creditors has served as a valuable inter-creditor coordination mechanism for

⁴ Apart from higher interest rates, Chinese loans are more likely to use features such as collateral and escrow accounts.

FIGURE 10

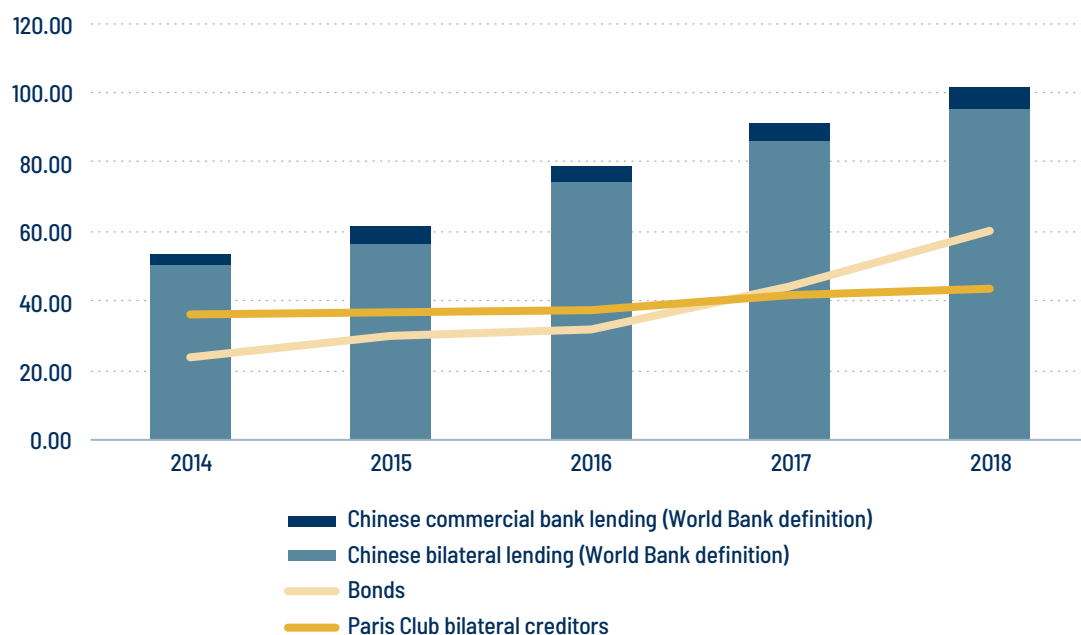
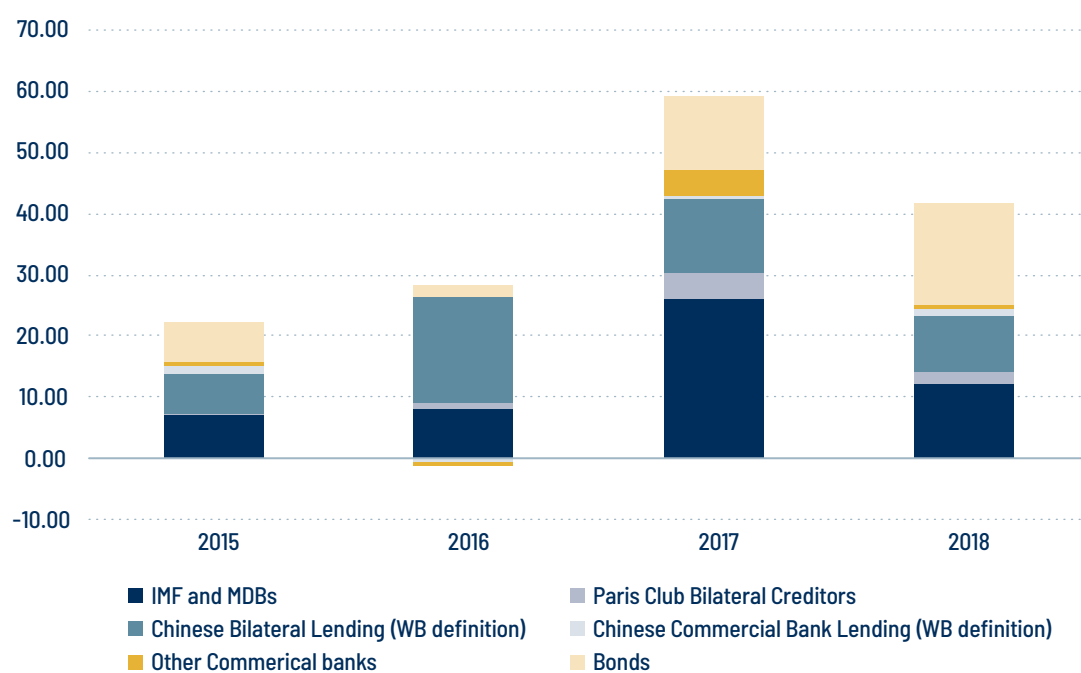
New creditors displacing the Paris Club World Bank data, stock outstanding (US\$ billions)

FIGURE 11

Flows to DSSI countries (publicly guaranteed external debt in the World Bank data, US\$ billion)

renegotiating official bilateral claims. Since its establishment in the 1950s, the Paris Club has hosted negotiations between debtors and creditors, introduced and expanded standard restructuring terms, promoted information sharing between the debtor and its creditors and among creditors, and facilitated coordination with the IMF, multilateral lenders, and most recently, with private capital market participants, to promote fair and efficient restructurings.

Although the Paris Club is primarily associated with government-to-government creditors, it has hosted many restructurings involving hybrid institutions with mixed ownership and some commercial characteristics, most notably export credit agencies. The club's six core principles, including information sharing, conditionality, and comparability of treatment,⁵ are meant to promote trust among creditors, reduce debt overhang, support growth and development in borrowing countries, and collectively achieve sustainable medium-term outcomes. Paris Club creditors' exposure to emerging market countries has fallen since the implementation of the HIPC initiative and the subsequent emphasis on grant financing. Lending by non-Paris Club official and commercial creditors, and capital markets issuance have grown in parallel, reviving some of the same concerns that had led to debt relief in the 2000s.

Debt distress associated with the pandemic presents a leadership opportunity for China, which could pave the way for other new creditors and help shape the international sovereign debt restructuring regime going forward. China can lead by example, joining the Paris Club with respect to its official claims, and restructuring its hybrid and commercial claims in a similarly transparent multilateral forum. While China's Ex-Im Bank has rescheduled some of its claims in conjunction with DSSI, the G-7 have criticized other Chinese lenders, as well as bondholders, for their failure to provide debt service relief to vulnerable countries on terms comparable to Paris Club creditors. Although China has renegotiated its overseas claims many times, including most recently a rescheduling in Ecuador and taking control of electricity transmission in Laos in exchange for debt relief, it has done so bilaterally, with limited or no disclosure of the terms, which raises sustainability and equity concerns. Imminent restructuring in Zambia, where both China and commercial creditors hold a material portion of the debt, presents an opportunity for enhanced cooperation.

“China can lead by example, joining the Paris Club with respect to its official claims, and restructuring its hybrid and commercial claims in a similarly transparent multilateral forum.”

Creditor participation in debt relief initiatives in response to common shocks, such as COVID-19 and more familiar capital account crises, should not depend on ill-fitting formal classifications such as “official” or “commercial.” All creditors with material claims on a distressed sovereign debtor must participate in debt relief initiatives fully and on comparable terms, consistent with any applicable legal constraints. Hybrid institutions combining official and commercial elements are becoming more common. Debating the formal status of China's lenders is unproductive against this background. Any restructuring will implicate this debt, regardless of its status. Creditor participation may vary in form, and may include new concessional financing. Sovereign debt restructuring architecture where burden-sharing among stakeholders rests on arcane formal distinctions is prone to arbitrage, undermines trust, and is ill-equipped to solve pandemic debt problems. An approach to debt crisis resolution where some creditors effectively finance repayment to others is politically unsustainable, and is likely to fail.

The prospect of a better-fitting restructuring forum in the future cannot excuse inaction today. Going forward, there is a strong case for a debt restructuring forum where institutions that combine features of official and commercial creditors would coordinate among themselves and with other stakeholders in a sovereign debt restructuring. Such a forum could help creditors with very different mandates and claims establish shared disclosure expectations, comparability of treatment standards, and debt relief and concessional financing parameters, among others. It could coordinate with the Paris Club and multilateral lenders, including the growing cohort of regional institutions, as well as private creditors. Adapting crisis management and debt restructuring institutions to reflect China's role and those of other new stakeholders is vital, but it will take time. Urgent response to the pandemic cannot wait for the adaptation process to run its course.

5 Solidarity, Consensus, Information Sharing, Conditionality, Case-by-Case, and Comparability of Treatment (<https://clubdeparis.org/en/communications/page/the-six-principles>).

5. Comprehensive and Meaningful Public Debt Disclosure

Inadequate sovereign debt and debt restructuring disclosure results in a faulty patchwork of information about direct and contingent claims against sovereigns. Lack of transparency undermines trust and makes it difficult to reach judgments about comparability. Sovereign borrowers should include robust disclosure requirements as part of public debt authorization, including guarantees and other forms of engaging the credit of the central government. Undisclosed debt would lack proper authorization, and would be harder to enforce in major financial jurisdictions. Authorization criteria should be transparent and well publicized to put creditors on notice that secret debts may not be enforced.

Public access to meaningful information about public debt is essential to the legitimacy in a public institution, and to the functioning of domestic and international financial systems. Inaccurate, incomplete, and fragmented debt disclosure is an old problem that has become more acute as more countries have tapped international financial markets, and new lenders with diverse priorities and constraints have come to play a bigger role in financing emerging market economies.

A patchwork of international institutional norms, practices, and domestic and international legal requirements has produced an incomplete and sometimes faulty picture of direct and contingent claims against sovereigns. The Organisation for Economic Co-operation and Development, the IMF, the World Bank, the Bank for International Settlements, United Nations agencies, the Paris Club, and national securities regulators are among the institutions that have collected information about debtor

and creditor exposures. Enterprising university researchers collect information on debt contract terms and restructurings, but it is far from comprehensive, and by definition depends on the particular interests of the collectors.

Accurate and timely information about the full scale of the public external debt—and the composition of governments' creditors—is far too difficult to obtain. For example, the World Bank's International Debt Statistics publication is among the best sources for such information, although it only reports the debts of countries that borrow from the World Bank Group. As of September of 2020, this data set did not have current information for end-2019 debt stocks. In a number of key countries, it potentially understates the actual exposure of the public sector through projects kept off the government's balance sheet that do not enter into public and publicly guaranteed external debt data.

A number of systemically important emerging market countries understate the true extent of their public

borrowing and their foreign currency exposure by borrowing through state-owned enterprises, notably state oil companies, which support the budget with dividends and other transfers. Some countries use the appearance of limited-recourse project structures to borrow off budget in foreign currency, but with the effective backing of the public sector. International financial institutions have sounded the alarm about the rise in collateralized sovereign debt not associated with investment projects, as well as quasi-secured debt that puts scarce government revenues under the control of individual creditors. Such arrangements shift risk and crisis losses onto vulnerable citizens and other creditors, including taxpayers in donor countries, and siphon off financing that should be used to fight the pandemic or restore balance of payments. Standard measures of public debt and public external debt tend to understate true vulnerabilities.

Risks associated with formally and informally secured debt and project finance need to be carefully managed. Properly documented collateralized debt is an accepted way to ensure repayment and reduce the cost of financing for the borrower. Project finance is a vital mechanism to attract capital for the essential infrastructure and other development needs of low- and middle-income countries. It is an established tool for transferring capital and know-how. However, transactions that entail multiple inter-linked contracts, special purpose companies, offshore accounts, and asset pledges, are vulnerable to abuse where institutions are weak and disclosure is poor. As a matter of domestic and external accountability, governments must ensure timely and comprehensive disclosure of financial terms that could put public finance at risk, or transfer control over essential public infrastructure. Disclosure requirements should include guarantees, security arrangements, offtake commitments, loans linked to forward commodity sales, and any other contingent obligation of the central government. Transfer of public infrastructure, such as a national electricity grid, to creditors in the event of default must clear the highest burden of transparency and accountability. Countries should have in place procedures for *ex ante* review of such arrangements for consistency with debt sustainability and development objectives. Technical assistance and multilateral surveillance should help ensure that such procedures follow international best practices.

Sovereign borrowers should establish and publicize robust debt disclosure requirements as part of public debt authorization, including guarantees and other forms of engaging the public credit. Debt contract enforcement is essential to the functioning of domestic and international markets. It is equally well-established that contracts made without authority, under duress, or on the basis of false or inadequate information run the risk of not being enforced. This is already the law in major financial jurisdictions. However, if domestic law in the borrowing country does not require disclosure as part of debt authorization, the mere fact that debt is hidden would not be a barrier to enforcing it in foreign courts. Governments borrow in secret for a variety of reasons, such as fear of revealing over-indebtedness or other dire economic conditions, creditor demands for confidentiality, and domestic governance failures, including official corruption. To help discourage such borrowing, multilateral lenders should help elaborate and promote best practices in authorization and disclosure, and provide technical assistance for countries willing to adopt them, especially those new to international borrowing. Official creditors should then condition their lending on countries' adherence to best practices that include comprehensive debt disclosure as part of authorization. Meaningful disclosure should be a necessary condition for contract enforcement.

“Meaningful disclosure should be a necessary condition for contract enforcement.”

Recent collaboration between international financial institutions and market participants to create and operationalize a platform for debt contract disclosure is a step in the right direction. Information about public debt should be made available on a public platform. Although research institutions and private trade associations may be able to host such information, public debt transparency is simply too important to be left to the vagaries of private finance and the interests of academics.

6. Promoting Simple Contingent Contracts for More Resilient Sovereign Debt Stocks

Sovereign borrowers should adopt, and official creditors should promote, greater use of maturity extension options and simple interest capitalization options consistent with recent market proposals. Pandemic-related uncertainty highlights the need for financial instruments to manage risks from a wide range of future shocks. We favor contingency features framed broadly, because it is very hard to predict any given shock with precision: hurricane clauses do not help in a pandemic. In addition to provisions that work within the basic structure of the bond market, there is ample scope for more equity-like options, such as commodity-indexed features, to help address known sources of volatility. Independent of market take-up, the official sector should offer contingent instruments immediately as part of this crisis response, to improve resilience in an uncertain environment. International financial institutions should consider ways to use official support to encourage the introduction of instruments that provide concessional support, such as full or partial interest forgiveness, in the event of a verified common shock, such as this pandemic.

Proposals for contingent sovereign debt instruments have a long history, but have, for the most part, failed to gain acceptance in the sovereign debt markets. Designs such as GDP-indexed bonds sought to move away from

the basic structure of fixed rate sovereign bonds, without much success.⁶ Researchers at the IMF and at the Bank of England have elaborated multiple design options to suit different economies, financial and other risk management

⁶ GDP-linked instruments have not found a broad market, in part because of concerns that GDP is measured by the issuing government. Commodity linked instruments have the advantage of being priced relative to a global market, and of providing greater relief in the event of most shocks. Commodity prices are typically more volatile than output. To date, though, such instruments have not been used even in cases where there would be obvious advantages to better aligning external debt service to a country's dominant export proceeds. Venezuela remains in default on its external sovereign bonds, and an oil-linked instrument would clearly align payments to payment capacity. If such options are fundamentally undervalued by the market, they cease to be attractive even in a restructuring case, as creditors may put an extremely high premium on fixed payments that push the burden of managing commodity price volatility entirely on the debtor, absent restructuring or default.

“We favor contingency features framed broadly, because it is very hard to predict any given shock with precision: hurricane clauses do not help in a pandemic.”

objectives. However, most existing contingent instruments to date have been issued as value recovery mechanisms, to sweeten a debt restructuring offer.

The COVID-19 shock and the associated extreme uncertainty highlight the value of simple, easy-to-price options that would work with the grain of the existing sovereign bond market. Maturity extension options would have allowed an automatic deferral of payment of principal until pandemic-driven uncertainty had abated. Interest capitalization options would have provided payment relief when revenues were plunging. Asset managers have recently argued for expanding the use of such options. Their proposals build on structures that market participants already know how to price, such as callable bonds. More contingent features enable countries to sustain a higher level of debt.

Interest capitalization or payment-in-kind options are less common in the bond market, but are not unusual in corporate loans. At a time of low global interest rates, such options should be comparatively cheap. At worst, in the absence of default, the investor receives the cash flows associated with the exercise of all the embedded options; at best, repayment is accelerated. Such options have been pioneered by small island economies, notably Grenada, subject to significant hurricane risk, which have introduced clauses allowing the deferment of payments in the event of large storms.

Broadly written options offer clear advantages to the sovereign borrower and its creditors. Because existing contingency triggers are written narrowly, they insure against a narrow category of risks. Such contracts, by design, do not protect against unforeseen risks. Hurricane bonds do not help in a pandemic, even though the pandemic may end up having a more catastrophic economic impact on tourism-dependent islands. An option that allows the sovereign borrower to defer payments for any reason, for a limited number of times, delivers relief without the cost of default, such as credit ratings downgrades. Creditors avoid the uncertainty and collective action problems that come with renegotiating contractual terms in the event of an unforeseen shock.

More powerful contingent instruments would automatically reduce interest payments and defer principal payments in the event of a shock beyond the issuer’s control, whether from hurricanes, earthquakes, or pandemics. They would go beyond providing relatively easy-to-price flow relief, and offer broader downside protection, such as interest forgiveness, in the event of natural disasters.

Official creditors should lead by example here and help manage uncertainty from the crisis by incorporating contingency features in official support. Multilateral institutions and bilateral creditors have experimented with contingent repayment features in the past; this crisis presents an opportunity and a stronger imperative to do so. If financial incentives, including co-financing, are provided by the official sector to facilitate the restructurings that follow from the COVID-19 shock, these should be linked to the use of options that offer substantial future downside protection.

7. Credit Ratings, Market and Regulatory Responses with Potential to Amplify Pandemic Shocks

A large number of sovereign borrowers have been downgraded since the start of the pandemic. Expectations of an automatic downgrade have contributed to countries' reluctance to engage with their official and private creditors, despite international consensus around the need for relief. Policy, regulatory, and market institutions should minimize obstacles to recognizing and dealing with debt problems. We further recognize that sovereign ratings actions can raise concerns about contagion and amplify concerns about financial stability and market liquidity. Official sector policy makers and sovereign borrowers would benefit from engaging with rating agencies, financial regulators, and the asset management community to consider how best to ensure that ratings actions do not become an impediment to dealing with debt problems.

Fear of a credit downgrade and its consequences, well founded and otherwise, can delay necessary debt restructuring, which in turn harms sovereign borrowers' economic and financial prospects in the medium term. Major credit rating agencies assign default ratings to sovereign debt in the event of failure to pay principal or interest on debt to private creditors, a distressed debt exchange to avoid payment default or unilateral change in payment terms, so long as the new terms reduce the original payment obligation. Although ratings methodology allows for discretion, sovereign borrowers perceive the action as automatic. Some credit rating agencies have put countries on downgrade watch in anticipation of a restructuring. Countries could expect to be upgraded quickly after a restructuring that improved their debt sustainability or

debt repayment profile, but not after a restructuring that brought no durable relief. Multiple sovereign borrowers have cited fear of downgrades and the consequent loss of market access they have come to associate with downgrades as reasons for their reluctance to participate in DSSI as originally designed, which had offered only a brief interest payment deferral.

In some cases, changes in sovereign ratings may also raise concerns about financial stability and market liquidity. Credit ratings embedded in market practices have the potential to amplify external shocks for some emerging market economies. Regulatory and prudential limits on banks' and insurers' holdings of sovereign debt securities prompt sales in response to a downgrade. Forced selling under regulatory or institutional mandates is most

“Fear of a credit downgrade and its consequences, well founded and otherwise, can delay necessary debt restructuring, which in turn harms sovereign borrowers’ economic and financial prospects.”

likely to be a concern for larger emerging market borrowers and for rating actions that move an issuer below the investment grade threshold. Unexpected downgrades can fuel contagion when leveraged and momentum-driven investors sell the bonds of other issuers with stronger fundamentals to generate liquidity in times of stress. Frontier markets are less exposed to these risks, as they have always relied more on investors with broader and more flexible mandates.

Policy makers should monitor the effects of ratings actions and ensure that they do not become an obstacle to sound debt management or result in diverting scarce

resources from fighting the pandemic. The number and depth of the downgrades is already significant.⁷ The three largest credit rating agencies have downgraded more than 30 sovereign borrowers so far in 2020, including Ghana, Mexico, South Africa, and Turkey, and have put more governments on downgrade watch. Limiting economic damage and aligning incentives for sovereigns and their creditors may require regulatory forbearance in some cases. Contingent instruments with built-in payment deferral options that avoid formal default should help avoid automatic downgrades. Investors ideally should have flexibility to look through the downgrades that accompany a decision to seek a debt rescheduling, and focus on the potential for a country to emerge from participation in a multilateral initiative to help low income countries with greater access to concessional financing and an improved long-term payments structure. Continued engagement with sovereigns, credit rating agencies, asset managers and other creditors should help inform national and international response.

⁷ The only notable upgrades this year were Argentina and Ecuador, which have just emerged from bond restructuring and Selective Default ratings.

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